IV. VIOLATIONS OF LAW: PENSION

A. The "Waterfall"

As discussed above, we believe the Waterfall – the City's practice of tapping Surplus Earnings to pay a growing list of retirement-related benefits – rested on a potentially dangerous conceptual error. However, it was not, standing alone, necessarily illegal or improper. The conceptual error is that Surplus Earnings are not truly "surplus." If the SDCERS actuary bases his actuarial calculations on an assumed *average* rate of investment return, then so-called "Surplus Earnings" (returns exceeding this assumed average in any particular year) are necessary to offset returns in below-average years. In this way, the desired average can be achieved over the long term.[484] To illustrate, if SDCERS's investment returns consistently alternate between years with 9% returns and years with 7% returns, and if the assumed average return is 8%, then there are no truly "surplus" earnings at all, since the 9% years are needed to offset the 7% years. The City, however, treated the entire amount above 8% as Surplus Earnings in all years, for example, when there were 9% returns.

On the other hand, SDCERS could experience consistent, long-term returns in excess of the 8% target.[485] In that case, it would be accurate to describe these as "surplus" earnings, because it had selected an assumption for investment returns that was too conservative. This would occur, for example, if the SDCERS returns consistently alternated between 7% and 11%. Some of its earnings, in this case, would be "surplus," but the amount of surplus would be different from (and smaller than) all returns in excess of 8%.

In 1980, when the City first began to tap Surplus Earnings to pay specific, pension-related expenses,[486] it may (or may not) have had earnings that were truly "surplus," that is, accumulated earnings that *consistently* exceeded the 8% target over the *long term*. To the extent it had such "surplus" earnings, commitment of these earnings to pay, initially the 13th Check, then a series of additional benefits, may not have been imprudent. The problem is that neither the City nor SDCERS ever made a determination of whether SDCERS had truly "surplus" earnings to begin with, never calculated what portion, if any, of returns in excess of 8% in any given year after 1980 were truly "surplus," and acted in the mistaken belief that all earnings in excess of 8% were "surplus."

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484 Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 14-15 (Feb. 12, 2002).

485 SDCERS calculated Surplus Earnings based on realized gains. While this approach may be expected to approximate net gains over a long period, it may produce inaccurate estimates in a given year.

486 San Diego, Cal., Ordinance O-15353 (Oct. 6, 1980).

Until 1996, SDCERS had built-in protection against the consequences of this kind of miscalculation.[487] To the extent that it was depleting earnings needed to maintain the long-term stability of the retirement system by using them to pay current benefits, the effect of this profligacy would show up in a growing pension funding gap. Although this situation was not ideal, it at least required City payments to increase in direct response to any depletion of SDCERS assets. This automatic rebalancing mechanism was eliminated in 1996.[488]

B. Manager's Proposal 1

By mid-2002, two years of weak and even negative investment returns, combined with significant new unfunded pension benefit obligations, had pushed SDCERS and the City to a crisis.[489] The temporary, badly-flawed "fix" for the crisis – MP-2 – won grudging approval only at the cost of a lot of short tempers and frayed nerves, and the "fix" itself quickly came undone under the pressure of litigation, a wave of disclosures of alarming financial information, and increasingly strident criticism of the City's management of its pension obligations. It is tempting to look at 2002 and 2003 as a period in which a "perfect storm" of unpredictable events came together to create a crisis, to which different parties then responded with different degrees of candor, professionalism, and regard for the public interest.

In fact, what brought SDCERS and the City to a crisis in 2002 and 2003 was not a "perfect storm" of unpredictable catastrophes, but a number of completely foreseeable financial challenges to a system debilitated by years of reckless mismanagement. The bear market of 2000 to 2003 was no more unusual in its intensity and duration than the eight-year long bull market that preceded it, and San Diego's package of employee retirement benefits does not appear to be unusually generous or expensive. Moreover, the whole point of financial planning is to be able to weather hard economic times. External events beyond the City Manager's control do not explain the crisis of 2002. Deliberate illegal and imprudent actions taken years before do.

The starting point is MP-1. We conclude that, for any one of a number of independent reasons, the SDCERS Board and the City acted illegally and improperly in enacting MP-1, which allowed the

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[487] Until 1996, the City's annual contribution was required to include a component sufficient to pay off any UAAL over an amortization period of 30 years. Overspending of system assets on current benefits would increase the UAAL, but this in turn would create a step-up in the City's annual payment obligation. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 10(f) (June 30, 2005).

[488] San Diego City Council Resolution R-287582 (July 2, 1996); Minutes, SDCERS Board Meeting at 31 (June 21, 1996).

[489] Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13-14 (Jan. 9, 2003).

City, with the full knowledge and acquiescence of all participants in the approval process, to avoid financial obligations imposed by state and local law and the fiduciary duties of the SDCERS Board.

The California Constitution, which trumps all other state and local legislation, guarantees to public employees an "actuarially sound retirement system."[490] Although whether or not a retirement system is actuarially sound is a question of fact to be determined under the circumstances of each case,[491] the *Wilson* court struck down as unconstitutional a proposed change in the State's method of funding the retirement system for State employees that bears strong similarities to MP-1. In *Wilson*, the State, because of budgetary constraints, sought to reduce its annual contributions to the retirement system by switching from a level contribution system, like that employed by San Diego before MP-1, under which retirement obligations were fully funded on a current basis, to one in which retirement obligations were funded one year in arrears.[492] The California Supreme Court held that it could not constitutionally do so.

In reaching this conclusion, the *Wilson* court relied expressly on a declaration by Richard Roeder, the father of the SDCERS actuary.[493] Richard Roeder maintained in *Wilson* that a change in funding that deferred the employer's payment obligation by one year undermined the actuarial soundness of the system because, in light of the deferral, "greater contributions would be required from future taxpayers."[494] In short, what *Wilson* found decisive was that the State's funding proposal had the effect of shifting *present* retirement costs onto *future* taxpayers.[495] This feature made the proposal actuarially unsound and, as a result, unconstitutional.

Wilson did not purport to announce a universal standard of actuarial soundness, and there is no single, settled definition of the term in either the law or the actuarial literature. Actuarial soundness requires funding the current costs of future obligations fully in the present, rather than leaving them to be absorbed by future contributors. The Navigant Report quotes with approval one working definition:

> The financial objective of the pension plan shall be to establish and receive contributions which will remain approximately level from year to year and will not have to be increased for future generations of citizens. The objective is achieved when contributions received each year by the pension

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490 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1135 (Cal. Ct. App. 1997) (holding that the California Constitution protected a state employee's "contractual right to an actuarially sound retirement system.").

491 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1139 (Cal. Ct. App. 1997).

492 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1117 (Cal. Ct. App. 1997).

493 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1141 (Cal. Ct. App. 1997).

494 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1141 (Cal. Ct. App. 1997).

495 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1141 (Cal. Ct. App. 1997).

> fund are sufficient both, (1) to fully cover the costs of benefit commitments being made to employees for their service being rendered in such year and, (2) to make a level payment which, if paid annually over a reasonable period of future years, will fully cover the unfunded costs of benefit commitments for service previously rendered.[496]

This definition echoes the standard employed in *Wilson*.[497] By this standard, SDCERS became actuarially unsound with the adoption of MP-1, and this unsoundness rendered MP-1 unconstitutional.

In *Wilson*, the State legislature acted to reduce (through delay) its annual pension contributions without approval of, or actuarial input from, the retirement board, which challenged the legislation on the ground that it would undermine the system's actuarial soundness.[498] With MP-1, the SDCERS Board, by contrast, *agreed* to the City's proposal, and its actuary expressly found that the system continued to be actuarially sound.[499] Nonetheless, there are significant similarities between MP-1 and the proposal found to be unconstitutional in *Wilson*, and we conclude the SDCERS actuary was wrong in finding that the system remained actuarially sound.[500]

SDCERS and the City both understood that, under MP-1, greater contributions would be "borne by the future generation" of taxpayers to make up for the rate relief granted to the City for the term of MP-1.[501] Under the logic of Richard Roeder's *Wilson* declaration, adopted by the *Wilson* court, this feature would render SDCERS actuarially unsound and MP-1 unconstitutional. While SDCERS actuary Rick

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496 Navigant Consulting, Inc., Investigation for the Board of Administration of the San Diego Employees' Retirement System at 98 (Jan. 20, 2006). Navigant does not identify the source of this definition.

497 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1139-40 (Cal. Ct. App. 1997).

498 *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109, 1123 – 24 (Cal. Ct. App. 1997).

499 Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 17 (Feb. 12, 2002); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2000, at 19 (Mar. 8, 2001); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 19 (Jan. 9, 1997); Minutes, SDCERS Board Meeting at 31 (June 21, 1996).

500 The 2005 V&E Report noted there is no "bright line" rule for determining when a system becomes actuarially unsound and did not reach any conclusion on whether MP-1 rendered the pension system actuarially unsound. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 70 (Draft July 15, 2005). The City Attorney's Interim Report No. 3 stated that whether a pension fund is "actuarially sound" is a matter of fact. Without stating explicitly that MP-1 and MP-2 caused the pension system to become actuarially unsound, Interim Report No. 3 found that the funding scheme dictated by MP-1 departed from the principles of level-cost financing and that the "deliberate underfunding" dictated by MP-1 and MP-2 violated the California Constitution. City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 18 (Apr. 9, 2005). The Reish Luftman Report similarly concluded that MP-1 violated the California Constitution by causing the pension system to become actuarially unsound. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 71 (Jan. 20, 2006).

501 Minutes, SDCERS Board Meeting at 16 (June 11, 1996).

Roeder expressly concluded, as of June 30, 1997, through June 30, 2001, that SDCERS was actuarially sound, for reasons stated below, we conclude he was either mistaken or was pressured into declaring a belief that he did not in fact have.[502]

Even if MP-1 were permitted by the California Constitution, however, it would still need to be lawful under the San Diego City Charter, and the argument is quite strong that it was not.[503] The City Charter provides in relevant part:

> The retirement system herein provided for shall be conducted on the contributory plan, the City contributing jointly with employees affected thereunder. Employees shall contribute *according to the actuarial tables adopted by the Board of Administration* for normal retirement allowances . . . The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, *as certified by the actuary . . . The mortality, service experience or other table calculated by the actuary and the valuation determined by him and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon.*[504]

The Charter sets out two requirements: (1) the City's contributions must be "substantially equal" to employee contributions; and (2) the employee contributions, that the City must match, must be calculated "according to the actuarial tables adopted by the Board."[505] And, the Charter concludes, the entire system must be "based" on conclusive and final tables and valuations determined by the actuary and approved by the Board.[506]

The requirement that the City's contributions be "substantially equal," rather than "identical," to employee contributions arguably gives the City some flexibility to "smooth" its payments by

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[502] Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1997, at 17 (Jan. 16, 1998); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1998, at 18 (May 5, 1999); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1999, at 17 (Feb. 14, 2000); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2000, at 19 (March 8, 2001); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 17 (Feb. 12, 2002). Mr. Roeder admitted at a SDCERS Board meeting held in 1996 that under MP-1, the System's liabilities would "be borne by the future generation." Minutes, SDCERS Board Meeting at 16 (June 11, 1996).

[503] In fact, in connection with a lawsuit brought by the San Diego Police Officers' Association ("SDPOA") against Mr. Aguirre, SDCERS, various Council members, various City officials, and other unnamed defendants, SDCERS admitted that the City failed to fund the pension system in accordance with City Charter, art. IX, § 143. SDCERS' Answer to SDPOA's Third Amended Complaint, *San Diego Police Officers' Association v. Aguirre,* No. 05 CV 1581H, at ¶ 47 (S.D. Cal. Apr. 17, 2006).

[504] San Diego City Charter art. IX, § 143 (emphasis added).

[505] San Diego City Charter art. IX, § 143.

[506] San Diego City Charter art. IX, § 143.

agreement with the Board, provided that these payments approximate the actuarial calculation used to set employee rates. The payment rates under MP-1, however, involved more than "smoothing." They were intended to be, and were, consistently and substantially below actuarially determined rates. Although the precise issue has not been tested in court, it is difficult to square MP-1 with the requirements of the City Charter.[507]

It is even more difficult to square MP-1 with the requirements of the Municipal Code. The Municipal Code in effect prior to November 18, 2002 provided:

> [T]he City shall contribute to the Retirement Fund in respect to members a percentage of earnable compensation as determined by the System's Actuary pursuant to the annual actuarial evaluation required by Section 24.0901.[508]

MP-1 cannot be made consistent with this legal requirement. The negotiated rates the City paid under MP-1 were not "determined by the System's actuary," and they certainly were not calculated "pursuant to the annual actuarial evaluation." The whole point of MP-1 was to avoid a payment calculated according to an "annual actuarial evaluation."

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[507] On June 8, 2006, the City entered into a Term Sheet for Settlement of a lawsuit brought by a SDCERS retiree against the City for violations of the City Charter and Municipal Code as a result of the City's underfunding of the pension system. First Amended Complaint, *McGuigan v. City of San Diego,* No. GIC 849883 (Cal. Super. Ct. Sept. 6, 2005); Term Sheet for Settlement, *McGuigan v. City of San Diego,* No. GIC 849883 (Cal. Super. Ct. June 8, 2006). The settlement, which must be approved by the City Council and the presiding judge, would result in $173 million being contributed to the retirement fund. *See* Term Sheet for Settlement, *McGuigan v. City of San Diego,* No. GIC 849883 (Cal. Super. Ct. June 28, 2005); Jennifer Vigil, *San Diego settles pension lawsuit,* San Diego Union-Tribune (June 9, 2006) *available at* http://www.signonsandiego.com/news/metro/pension/20060609-9999-7m9pension.html.

City Attorney Michael J. Aguirre has alleged in a cross-complaint against SDCERS that MP-1 is illegal because its implementation violated the California Constitution, the San Diego City Charter, the San Diego Municipal Code, and the California Government Code. Mr. Aguirre made the same allegations in his motion for summary judgment, except he did not claim that MP-1 violated the Municipal Code. Mr. Aguirre requested a judicial declaration that MP-1 and the benefits granted thereunder are illegal and void. However, the Court denied Mr. Aguirre's request because it found, in part, that there is a triable issue of fact concerning the "nature, extent, terms" and effect of MP-1 and whether the benefit increases were separate agreements from MP-1. The Court also noted that SDCERS's adoption of MP-1 cannot be found to have violated the debit limit laws, as set forth in California Constitution Article XVI, section 18 and City Charter section 99, because City Charter section 99 does not apply to SDCERS. Order After Hearing, *San Diego City Employees' Ret. Sys. v. Aguirre,* No. GIC 841845 (Cal. Super. Ct. Mar. 6, 2006).

The Reish Luftman Report and the City Attorney's Interim Report No. 3 concluded definitively that MP-1 violated Section 143 of the City Charter. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 51, 67, 71 (Jan. 20, 2006); City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 20 (Apr. 9, 2005). The 2005 V&E Report mentioned this issue, but did not reach any conclusion. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 27 (Draft July 15, 2005).

[508] Former San Diego Municipal Code § 24.0801 (adopted Oct. 25, 1962, by San Diego City Council Ordinance O-8744).

In November 2002, the City amended Section 24.0801 of the Municipal Code to provide:

> The City will contribute to the Retirement Fund, on behalf of Members employed by the City, the amount agreed to in the governing Memorandum of Understanding between the City and the Board.[509]

This Code amendment, enacted as part of MP-2,[510] cannot salvage MP-1. Moreover, the amendment itself is legal only if it is consistent with the City Charter and the California Constitution. It is inconsistent with both.[511]

In summary, MP-1 was illegal under the Municipal Code, the City Charter, and California Constitution. Remarkably, no one at either the City or SDCERS appears even to have considered the question of MP-1's legality under the Municipal Code, City Charter, or California Constitution, much less to have come up with a plausible affirmative answer to the question. While this remarkable oversight may be relevant to the question of whether anyone acted deliberately in violation of law, it does not alter the conclusion that MP-1 was illegal.

To state that MP-1 was illegal is *not* to state that the retirement benefits granted by the City in connection with MP-1 are illegal and unenforceable. While it is undeniable that the circumstances under which the 1996 "meet and confer" was conducted carried the taint of MP-1's illegality, it cannot be said that the benefit agreements themselves were invalid.[512]

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509 San Diego Municipal Code § 24.0801 (amended Nov. 18, 2002).

510 Minutes, San Diego City Council Meeting at 8-11 (Nov. 18, 2002). This amendment to the Municipal Code, along with the benefit package contemplated by MP-2, passed by an 8-1 vote, with Council members Scott Peters, George Stevens, Byron Wear, Toni Atkins, Brian Maienschein, James Madaffer, Ralph Inzunza, and Mayor Murphy voting to approve it and Councilmember Donna Frye opposed. Minutes, San Diego City Council Meeting at 9-11 (Nov. 18, 2002). Nevertheless, Councilmember Frye, along with the rest of the City Council, voted to approve the contribution scheme under MP-2. Minutes, San Diego City Council at 39-40 (Nov. 18, 2002) (Council members Scott Peters, George Stevens, Toni Akins, Byron Wear, Brian Maienschein, Donna Frye, James Madaffer, Ralph Inzunza, and Mayor Murphy voted to approve; none opposed).

511 The Reish Luftman Report concluded summarily that MP-1 violated the Municipal Code. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 71 (Jan. 20, 2006). The City Attorney's Interim Report No. 3 concluded that MP-1 violated former Municipal Code § 24.0801. Interim Report No. 3 also found that the November 18, 2002 amendment to this Municipal Code section was beyond the City's power since it conflicted with the Charter. City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 20 (Apr. 9, 2005). Vinson & Elkins mentioned this issue, but did not reach any conclusion. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP., Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 28 (Draft July 15, 2005).

512 Several of the legal bases City Attorney Aguirre puts forth for voiding the benefit enhancements—both in his Interim Reports and in the pending legal action between the City and SDCERS—presume that the illegality of MP-1 and MP-2 applies to all the separate components of the proposals. In several of his Interim Reports, Mr. Aguirre cites to *Domar Elec. v. City of Los Angeles* for the proposition that MP-1 and MP-2, in totality, are void because they violated the City Charter. *Domar Elec. v. City of Los Angeles*, 9 Cal. 4th 161, 171 (1994) ("it is well settled that a charter city may not act in conflict with its charter. Any act that is violative of or not in compliance with the charter is void."). *See* City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related

Though the conferral of enhanced benefits was conditioned upon the approval of the "rate stabilization plan" component of MP-1, the new pension benefits granted in 1996 were nonetheless authorized through the ordinary course of the labor negotiation process. The approval of the Manager's Proposal by the SDCERS Board did not in and of itself authorize the benefit enhancements, as the proposal noted that "[t]he following benefit changes do not require any action by the CERS Board, but rather are presented as part of the overall proposal."[513] The City Council approved by resolution the tentative agreements reached between the City and the labor unions.[514] Subsequently, the City Council adopted ordinances approving the Memoranda of Understanding ("MOUs") between the City and labor unions and amending the Municipal Code with the new benefit provisions contained in those MOUs.[515] Pursuant to the San Diego City Charter, these retirement benefit amendments did not become effective until SDCERS approved them in April 1997.[516] Despite the illegality of the City's arrangement to underfund the pension

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to the SDCERS Pension Fund at 18 (Apr. 9, 2005); City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 54 (July 1, 2005). More broadly, in his First Amended Cross-Complaint in the pending matter between SDCERS and the City over, among other things, the legality of benefit enhancements, the City Attorney provides a number of specific bases – under the California Constitution, California statutory law and San Diego municipal law – in support of the proposition that MP-1 and MP-2 were illegal. First Amended Cross-Complaint, *San Diego City Employees' Ret. Sys. v. Aguirre*, No. GIC 841845, at 26-28 (Cal. Super. Ct July 2005). However, Mr. Aguirre does not similarly provide an independent basis for his assertion that "[a]ll benefits obtained by virtue of the illegal acts herein described are void." First Amended Cross-Complaint, *San Diego City Employees' Ret. Sys. v. Aguirre*, No. GIC 841845, at 26-28 (Cal. Super. Ct July 2005). Mr. Aguirre's broad arguments fail to consider the independent legality of the benefits granted to SDCERS members. In fact, most of the benefit enhancements were legal and appropriate subjects of labor negotiation. Given the substantive validity of the benefits conferred in connection with both MP-1 and MP-2, it is not likely that a court would summarily void *all* aspects of the proposals without considering the workability of such a far-reaching remedy many years after the fact.

513 City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 2.

514 San Diego City Council Resolution R-287582 (July 2, 1996). The resolution passed 7-0, with Council members Harry Mathis, Byron Wear, Christine Kehoe, George Stevens, Barbara Warden, Valerie Stallings, Judy McCarty, Juan Vargas, and Mayor Golding voting to approve the measure. Minutes, San Diego City Council Meeting at 22 (July 2, 1996).

515 San Diego, Cal., Ordinance O-18392 (Mar. 31, 1997); San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997). Voting to amend the Municipal Code were Council members Harry Mathis, Byron Wear, Christine Kehoe, George Stevens, Barbara Warden, Valerie Stallings, Judy McCarty, Juan Vargas, and Mayor Golding. Minutes, San Diego City Council at 6 (Mar. 31, 1997). Voting to approve the MOUs were Council members Harry Mathis, Byron Wear, George Stevens, Valerie Stallings, Judy McCarty, Juan Vargas, and Mayor Golding. Council members Christine Kehoe and Barbara Warden were not present. Minutes, San Diego City Council at 4 (Feb. 25, 1997)

516 San Diego City Charter art. IX, § 143.1. At the March 21, 1997 SDCERS Board meeting, the Board approved election materials for an April vote among SDCERS members about the retirement benefits that had been adopted by the City Council in February 1997. Minutes, SDCERS Board Meeting at 15-18 (Mar. 21, 1997). During the April 18, 1997 SDCERS Board meeting, Lawrence Grissom informed the Board that a "Special Conference Call Board meeting to ratify the vote of the membership" would be held on April 21, 1997. Minutes, SDCERS Board Meeting at 20 (Apr. 18, 1997). The Municipal Employee Association's Complaint in Intervention in the pending action between SDCERS and the City alleges that a majority of SDCERS members voted in April 1997 to approve the ordinances amending the Municipal Code with the agreed-upon benefit enhancements. San Diego Municipal

fund through MP-1, the benefit enhancements granted in connection with this scheme were implemented through valid MOUs and approved by both the City and SDCERS in accordance with the City Charter and Municipal Code.

Moreover, many City employees likely relied to their detriment (if the extensive benefit enhancements were to be considered void) in either choosing to retire (to start collecting their pensions) or maintaining positions with the City (because of the handsome pension benefits available).[517] A court is likely to place great weight on this detrimental reliance before sweeping aside benefits that had been on the books for years, particularly considering the effect on City employees and retirees who had no part in crafting or approving the illegal components of the proposals.[518]

Most importantly, the benefit enhancements conferred through the MOUs (and corresponding Municipal Code amendments) became vested in SDCERS members as contractual rights protected by both the California and United States Constitutions.[519] As the California Supreme Court has stated, "[a]n employee's contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee's subsequent tenure."[520] Moreover, an employee's "pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."[521] In other words, there are constitutional limits placed on the City's ability to eliminate retirement benefits after they have been granted. The City must provide comparable new advantages to members of the pension system if it seeks to modify or terminate the new benefits conferred in 1997 or thereafter.[522] Thus, the City cannot unilaterally terminate vested pension

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Employees Association's Complaint in Intervention, *San Diego City Employees' Ret. Sys. v. City of San Diego*, No. GIC 851286, at 3,4 (Cal. Super. Ct. Aug. 10, 2005).

517 *See, e.g., San Diego Police Officers' Association v. Aguirre,* No. 05 CV 1581H at 34 (S.D. Cal. Aug. 9, 2005) (alleging that MP-1 provided the SDPOA with contractual rights to receive pension benefits in exchange for its service to the City).

518 *See, e.g., City of Sacramento v. Pub. Employees' Ret. Sys.*, 22 Cal. App 4th 786, 798 (Cal. Ct. App. 1994) (preserving contested enhanced pension benefits granted under a statutory amendment, noting that the "firefighters who were granted advantages by that amendment are entitled to judicial protection of the rights which accrued as a result of their continued, faithful employment in reliance upon the law during the period prior to the subsequent legislation.").

519 U.S. Const. art. I, § 10; Cal. Const. art I, § 9; *United Firefighters of Los Angeles City v. City of Los Angeles*, 210 Cal. App. 3d 1095, 1102 (Cal. Ct. App. 1989) ("Unlike other terms of public employment, which are wholly a matter of statute, pension rights are obligations protected by the contract clause of the federal and state Constitutions.").

520 *Betts v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 21 Cal. 3d 859, 866 (Cal. 1978).

521 *Betts v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 21 Cal. 3d 859, 863 (Cal. 1978).

522 *Betts v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 21 Cal. 3d 859, 864 (Cal. 1978). A public employer must meet a "reasonableness" test to modify vested pension benefits: "alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which

benefits without granting concessions to plan members in return. It is likely a court engaging in a careful analysis of the competing interests would inevitably conclude the City's contractual pension obligations to its public employees is an impediment to, if indeed, it does not preclude, voiding benefits that SDCERS members have been relying upon for almost a decade.

Further, regardless of what employees are legally entitled to, the City is, of course, free to agree to provide its employees with whatever salary and benefits, including retirement benefits, it chooses.[523]

SDCERS Board members, City officials, the City Council and the then-Mayor may claim that they did not know they were violating specific statutory and Constitutional requirements when they enacted MP-1. Separate and apart from these requirements, however, fiduciary principles rooted in the California Constitution, common law, and common sense also place strict limitations on how the SDCERS Board may act.[524] Unlike the specific statutory and constitutional restrictions discussed above, SDCERS Board members cannot credibly claim to have been unaware of these fiduciary principles.[525] We conclude the SDCERS Board *also* violated its fiduciary duty in enacting MP-1, that City officials encouraged it to do so, and that decision-makers in both camps (including those with a foot in each) knew what they were doing, as discussed further below.[526]

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result in disadvantage to employees should be accompanied by comparable new advantages." *Allen v. City of Long Beach*, 45 Cal. 2d 128, 131 (Cal. 1955).

[523] City Attorney Aguirre has taken the contrary position that the benefits are voidable. *See* City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 12 (Apr. 9, 2005); Third Amended Cross-Complaint, *San Diego Employees' Ret. Sys. v. Aguirre*, No. GIC 841845 (Cal. Super. Ct. Sept. 30, 2005); Defendants and Cross Complainants San Diego City Attorney Michael J. Aguirre and the City of San Diego's Notice of Motion for Summary Judgment or, in the Alternative, Summary Adjudication of the Issues, *San Diego Employees' Ret. Sys. v. Aguirre*, No. GIC 841845 (Cal. Super. Ct. Mar. 15, 2006).

[524] Cal. Const. art. XVI, § 17; *Bandt v. Board of Retirement, San Diego County Employees Ret. Ass'n*, 136 Cal. App. 4th 140, 156 (2006) (holding that the Board's duty to act in the best interests of its members takes precedence over any other duty the board may have, including the objective of minimizing employer contributions); *Corcoran v. Contra Costa County Employees Ret. Board*, 60 Cal. App. 4th 89, 94 (1997) (finding that the Board must place the needs of the fund's beneficiaries above all other duties to ensure the financial integrity of the assets); *City of Sacramento v. Public Employees Ret. Sys.*, 229 Cal. App. 3d 1470, 1493 (1991) ("even assuming article XVI, section 17 creates a duty to minimize employer contributions, it cannot be construed to require PERS [the Public Employee's Retirement System] to manage the retirement system in a way which would favor an employer over the beneficiaries to whom it owes a fiduciary duty").

[525] *See, e.g.*, Minutes, SDCERS Board Meeting at 20-21 (July 11, 2002); Minutes, SDCERS Board Meeting at 16 (June 21, 1996); Draft Minutes, SDCERS' Board Strategic Planning Workshop (Mar. 21-23, 1996).

[526] The San Diego Police Officers' Association ("SDPOA") has alleged that City Attorney Aguirre, the City, Council members, City Officials, SDCERS, and the Board violated fiduciary duties owed to the SDPOA by allowing the City to divert funds for unlawful uses which are inconsistent with the best interest of the beneficiaries. The SDPOA claimed that this diversion of funds contributed to the underfunding of the pension and the misappropriation of the benefits of the SDPOA members. Third Amended Complaint, *San Diego Police Officers' Association v. Aguirre*, No. 05 CV 1581H, at ¶¶ (S.D. Cal. Mar. 21, 2006).

The California Constitution, article XVI, section 17, provides:

> [T]he retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system . . .
>
> The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and selected services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system . . .
>
> A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty. . . .

The Constitutional provisions giving retirement boards "plenary" authority over, and "sole and exclusive fiduciary responsibility" for, the assets and administration of the retirement system and declaring that the Board's duty to its participants and their beneficiaries "shall take precedence over any other duty" were added by Constitutional amendment in 1992.[527] The "Findings and Declarations" accompanying the proposed (and later adopted) amendment include the following:

> (c) Politicians have undermined the dignity and security of all citizens who depend on pension benefits for their retirement by repeatedly raiding their pension funds.
>
> (d) . . . To protect the financial security of retired Californians, politicians must be prevented from meddling in or looting pension funds.
>
> (e) Raids by politicians on public pension funds will burden taxpayers with massive tax increases in the future.
>
> (f) To protect pension systems, retirement board trustees must be free from political meddling and intimidation.[528]

It is difficult to imagine a clearer declaration of Constitutional intent that retirement boards function independently of the political process and act solely in the interests of their members. In approving MP-1, the SDCERS Board failed to satisfy this standard.

The SDCERS Board has no proper role in *setting* retirement benefits.[529] That job belongs to the City.[530] The SDCERS Board's job is to ensure the *payment* of benefits determined by others by

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527 California Pension Protection Act of 1992, Prop. 162, § 17 (Nov. 4, 1992).

528 California Pension Protection Act of 1992, Prop. 162, § 2, "Findings and Declarations" (Nov. 4, 1992).

529 San Diego City Charter art. IX.

determining annual contribution requirements for the City and its employees and by managing the assets under its control.[531] Although the California Constitution also obligates the SDCERS Board to keep employer (City) contributions to a minimum, this obligation may not conflict with the Board's primary obligation to provide secure funding for members' benefits.[532] If two possible courses of action provide the *same* financial security for members' benefits, the Board should choose the one that requires the lower City contribution, but the Board may not impair the financial security of members' benefits in order to reduce the City's payment obligations.[533]

MP-1 did just that: it reduced the flow of funds to the retirement system, an obvious negative for SDCERS, in order to benefit the City, which had its payment obligations reduced, while creating no compensating benefit whatsoever for SDCERS. This was a violation of the Board's duty. Neither of the supposed benefits of MP-1 – rate relief for the City, and benefit increases made possible by the rate relief – was a benefit the SDCERS Board was entitled to consider. It could press for lower contribution rates for the City, but not if, as in the case of MP-1, these lower rates came at the direct expense of funds available to SDCERS. And SDCERS is not in the business of promoting increases in retirement benefits: it is in the business of *funding* whatever level of benefits the City, through the political process, elects to confer on its employees.[534]

Both the SDCERS actuary, Rick Roeder, of Gabriel, Roeder, Smith & Company, and its fiduciary counsel, Dwight Hamilton, of Hamilton and Faatz, "approved" MP-1.[535] Mr. Roeder was reported to have said that MP-1 was a sound proposal.[536] Mr. Hamilton said: "[T]he Board [is] acting within the discretion granted to [it] and discharging its fiduciary duties set forth in Article XVI, Sec. 17, of the California Constitution."[537] For a variety of reasons, we think that neither the SDCERS Board nor the City officials who pressed the adoption of MP-1 can take any comfort in this "approval."

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530 San Diego City Charter art. III, §§ 11.1 and 11.2; San Diego City Charter art. IX, § 141.

531 San Diego City Charter art. IX, § 143, 144.

532 San Diego City Charter art. IX, § 143; *City of Sacramento v. Public Employees Ret. Sys.*, 299 Cal. App. 3d 1470, 1493 (1991).

533 Cal. Const. art. XVI, § 17(b).

534 San Diego City Charter art. IX, § 143.

535 Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, SDCERS Administrator (June 21, 1996); Minutes, SDCERS' Retirement Board of Administration Special Workshop at 15 (June 11, 1996).

536 Minutes, SDCERS' Retirement Board of Administration Special Workshop at 15 (June 11, 1996).

537 Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996).

Neither Mr. Roeder nor Mr. Hamilton identified a specific benefit that SDCERS received from MP-1 that would have allowed the Board to approve it.[538] One can imagine circumstances in which there might have been such a benefit. If the City had been on the verge of a general default on its obligations, for example, the SDCERS Board might reasonably have traded a lower payment amount for a greater certainty that payment would actually be made: half a loaf is better than none. In other words, payments below actuarial rates in early years might reasonably have been traded for payments above actuarial rates – perhaps funded by anticipated future increases in City revenues – in later years. But neither of these possible situations was in fact the case, and neither Mr. Roeder nor Mr. Hamilton addressed any other specific benefit to SDCERS from MP-1.

Moreover, neither Mr. Roeder nor Mr. Hamilton concluded that MP-1 *was* in the interests of retirement system members.[539] Instead, they indicated the SDCERS Board *could find* that MP-1 was in the interests of retirement system members.[540] We could not find evidence demonstrating the SDCERS Board actually made such a finding, or could have done so in good faith. Certainly the Board was no more successful than Mr. Roeder or Mr. Hamilton in identifying a benefit to SDCERS that offset the detriment of reduced funding and permitted the Board to approve MP-1.

Put another way, the conclusion SDCERS's counsel reached, after the fact, about MP-2 – that the Board violated its fiduciary duty in approving it – applies with the same force, for the same reasons, to MP-1.[541] In each case, the SDCERS Board gave up something of significant value to its members and got nothing in return. Similarly, Morrison & Foerster concluded in 1995 that approval of a much more limited predecessor of MP-1 was not within the Board's fiduciary discretion.[542] The opinions of the professionals who approved MP-1 cannot be squared with, and have no satisfactory answer for, the arguments advanced by Morrison & Foerster in 1995 and Seltzer Caplan in 2003.

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538 Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996); Minutes, SDCERS Board Meeting (June 21, 1996); Minutes, SDCERS' Retirement Board of Administration Special Workshop (June 11, 1996).

539 Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996); Minutes, SDCERS Board Meeting (June 21, 1996); Minutes, SDCERS' Retirement Board of Administration Special Workshop (June 11, 1996).

540 Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996); Minutes, SDCERS Board Meeting at 16-18 (June 21, 1996); Minutes, SDCERS' Retirement Board of Administration Special Workshop at 21 (June 11, 1996).

541 *See* Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., cc to Michael A. Leone, Esq. (Mar. 5, 2003).

542 Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (May 9, 1995) (stating that "actuarial loss prevents a finding that the funds represent actuarially available funds . . . without the expected actuarial gain . . . it is not within the Board's fiduciary responsibility to approve the Auditor's request.").

In summary, we conclude the SDCERS Board violated its fiduciary duties in approving MP-1.[543] But the SDCERS Board is not the only party that bears responsibility for MP-1. The City officials who proposed, advocated, and helped approve MP-1 in their dual capacity as SDCERS Board members, knew the sole purpose of MP-1 was to provide short-term financial relief for the City and created no benefit whatsoever for retirement system members. These City officials caused a funding scheme to be adopted which, whether they knew it or not, was in violation of the California Constitution, the City Charter, the Municipal Code, and a breach of the SDCERS Board's fiduciary duty.[544]

C. Manager's Proposal 2

Although much of the prior examination of San Diego's pension crisis has focused on events leading up to, and culminating in, MP-2, our discussion of MP-2 will be much briefer. We conclude the SDCERS Board, at the instigation of the City, first abandoned its obligations to retirement system members not in 2002, but in 1996. We have concluded MP-1 was illegal and a violation of the Board's fiduciary duties. MP-2 did nothing to correct these illegalities.[545] Some City Council and SDCERS Board members may have believed that, under at least some possible circumstances, MP-2 would have provided increased City funding of pension obligations than was required under MP-1. As we discuss throughout this report, this belief, if anyone held it, was false. The only circumstance under which MP-2 might have benefited SDCERS, compared with what it was entitled to receive under MP-1, was if the funding ratio floor of 82.3% was *not* hit as of June 30, 2002, and this did not turn out to be the case. Even if MP-2 had provided, or was expected to provide, benefits to SDCERS, it would not have corrected fully the illegality of the MP-1 funding mechanism, and the SDCERS Board members who approved or acquiesced in the continuation of City funding at rates below the

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[543] The Reish Luftman Report concluded that "the Board did not engage in a prudent process or make an informed and reasoned decisions [sic] as required under the prudent person rule," and failed to sufficiently question the advice it received from its fiduciary counsel and actuary, thereby breaching its fiduciary duty in approving MP-1. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 79-80 (Jan. 20, 2006). The City Attorney's Interim Report No. 6 similarly concluded that the SDCERS Board breached its fiduciary duty in approving MP-1, noting that "[p]ension plan fiduciaries violated their constitutional duty to prudently manage the City's pension plan," and did not ask "the right questions." City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 35 (July 1, 2005). Vinson & Elkins did not discuss the fiduciary duties of the SDCERS Board in voting on MP-1, stating that "[t]he legality of MP1 was not specifically addressed in the V&E Report." Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP , Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 26 (Draft July 15, 2005).

[544] The City Attorney's Interim Report No. 3 found that the City Council induced the SDCERS Board to violate its fiduciary duties by enticing the Board with "special benefits." This Report cited no law regarding the liability for inducing another to breach a fiduciary duty. City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 21 (Apr. 9, 2005). Neither Navigant nor Vinson & Elkins discussed this issue.

[545] The sole difference is that MP-2 did not violate the Municipal Code, which was amended to permit MP-2. Because this amendment itself violated the City Charter and California Constitution, however, this distinction is entirely immaterial.

Annual Required Contribution would have violated the California Constitution, the City Charter, and their fiduciary duties for all of the reasons discussed in detail above in connection with MP-1.

Moreover, to the extent MP-2 was in fact expected to have an impact on the City's payments to SDCERS, the expected impact was to *reduce* those payments compared with what was required under MP-1, not increase them. MP-2 removed one of the primary protections for SDCERS contained in MP-1, and to this extent it not only perpetuated a funding mechanism that was already illegal and improper, but also aggravated it. MP-2, thus, also represented a new and independent illegal act by the SDCERS Board, at the instigation of the City.

As with MP-1, MP-2 did not benefit SDCERS at all.[546] By the time MP-2 was formally approved by the City Council in November 2002, the fiscal year ending June 30, 2002 was already over. Although the result was not yet "official," it was obvious to everyone that the funded ratio floor of 82.3% – the MP-1 trigger – would be breached as of the fiscal year ending on June 30, 2002. Mr. Grissom and Ms. Webster knew no later than April 2002 that the funded ratio was likely to be 80%. Since that time, nothing had happened to shrink SDCERS's liabilities or increase the City's funding, and the financial markets had continued their slide. The fact that the MP-1 trigger was in fact hit as of June 30, 2002, and that this was obvious to everyone in November 2002, made a mockery of the only argument that SDCERS received *some* benefit from MP-2, namely, increased payments from the City if the trigger was not hit. In light of the fact that the trigger had in fact been hit, MP-2 served solely to give the City relief from its obligations under MP-1, which in turn had served solely to give it relief from its obligation to make a full ARC each year. In consequence, for the reasons discussed under our analysis of MP-1, MP-2 violated the applicable provisions of the California Constitution, the San Diego City Charter, and the fiduciary duties of the SDCERS Board members who voted to approve it. Our conclusion about MP-2 is confirmed by the public disclosure in late 2005 that SDCERS's own counsel concluded, in evaluating possible responses to the *Gleason* litigation in

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[546] The City Attorney's Interim Reports concluded, without making apparent their basis, that MP-1 and MP-2 were both illegal and a breach of the Board's fiduciary duty. City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials at 98-99 (Feb. 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund at 21 (Apr. 9, 2005). The legal analysis accompanying the Navigant Report concluded that MP-2 was illegal and improper in the same manner as MP-1. Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System at 81 (Jan. 20, 2006). Vinson & Elkins found that MP-2, as with MP-1, put a majority of the Board in a position that appeared to compromise their independence by voting on their own benefits, but reached no conclusion as to whether the Board breached its fiduciary duty. Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP , Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 70 (Draft July 15, 2005).

In addition, Dean Roberts, the acting City of San Diego budget director, stated that no funds were identified in or provided out of the 2002 general fund budget to cover the liability incurred by the MP-2 benefit increases or in any subsequent budget. Declaration of Dean Roberts In Support of Defendants' and Cross-Complainants' Motion For Summary Judgment/ Adjudication, *San Diego Employees' Ret. Sys. v. Aguirre,* No. GIC 841845 (Cal. Super. Ct. Mar. 15, 2006).

early 2003, that MP-2 was a violation of the Board's fiduciary duties, violations which were instigated by the City.[547]

D. Violations of the Internal Revenue Code

SDCERS operates as a retirement system trust fund under Section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC").[548] As a plan qualified under Section 401(a), SDCERS receives a tax exemption, pursuant to IRC Section 501(a), on monies accruing within the pension trust fund.[549] The City has demonstrated a history of noncompliance with the IRC in the manner in which it funds and administers healthcare benefits for employees. Between 1982 and 2005, the use of SDCERS Surplus Earnings to fund retiree healthcare benefits and the administration of the retirement healthcare program through SDCERS contravened the qualification requirements of IRC Section 401(a) and IRC Section

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547 A lawsuit brought by SDCERS member William R. Newsome, III against SDCERS, the City, and unnamed defendants, alleged that the Board breached its fiduciary duties when it entered into MP-2. Complaint, *Newsome v. San Diego City Employees' Ret. Sys.*, No. GIC 856841 (Cal. Super. Ct. Nov. 14, 2005). City Attorney Michael J. Aguirre has alleged that MP-2 is illegal because its implementation violated the California Constitution, the San Diego City Charter, the San Diego Municipal Code, and the California Government Code. Mr. Aguirre, in his motion for summary judgment, requested a judicial declaration that MP-2 and the benefits granted thereunder are illegal and void. However, the Court denied Mr. Aguirre's request because it found, in part, that there is a triable issue of fact concerning the "nature, extent, terms" and effect of MP-2 and whether the benefit increases were separate agreements from MP-1. The Court also noted that SDCERS's adoption of MP-2 cannot be found to have violated the debt limit laws, as set forth in California Constitution Article XVI, section 18 and City Charter section 99, because City Charter section 99 does not apply to SDCERS. Final ruling; *San Diego City Employees' Ret. Sys. v. Aguirre,* No. GIC 814845 (Cal. Super. Ct. July 10, 2006); Defendants and Cross-Complainants San Diego City Attorney Michael J. Aguirre and the City of San Diego's Notice of Motion and Motion for Summary Judgment or, in the Alternative, Summary Adjudication of Issues, *San Diego City Employees' Ret. Sys. v. Aguirre,* No. GIC 814845 (Cal. Super. Ct. Mar. 15, 2006); Third Amended Cross-Complaint, *San Diego City Employees' Ret. Sys. v. Aguirre,* No. GIC 841845 (Cal. Super. Ct. Sept. 30, 2005). SDCERS is seeking a judicial determination that it can continue to pay retirement benefits despite Mr. Aguirre's direction to City Auditor and Comptroller John Torrel to instruct SDCERS to cease payment of certain benefits because they are illegal. Complaint for Declaratory Relief, *San Diego City Employees' Ret. Sys. v. City of San Diego,* No. GIC 851286 (Cal. Super. Ct. July 26, 2005). In a class action lawsuit brought by David Wood, a member of SDCERS, against Robert Blum, his partner Constance Hiatt, their law firm Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP ("Hanson Bridgett"), and other unnamed defendants, Mr. Wood alleged that the SDCERS Board violated its fiduciary duties when it entered into MP-2. That lawsuit and another action brought by SDCERS against the same defendants were dismissed when the class action settlement was approved by the court on June 13, 2005. Pursuant to the settlement, SDCERS is entitled to receive from Blum's, Hiatt's, and Hanson Bridgett's professional liability insurer the policy limits, amounting to, as of April 15, 2005, approximately $14,631,000. Class Action Complaint, *Wood v. Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP, et al.,* No. GIC 830558 (Cal. Super. Ct. May 25, 2004); Judgment Approving Settlement of Class Action and Dismissing Action, *Wood v. Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP, et al.,* No. GIC 830558 (Cal. Super. Ct. June 13, 2005).

548 San Diego Employees' Retirement System, Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2003 at 46 (Dec. 1, 2003).

549 26 U.S.C. § 501(a) (West 2006).

401(h).[550] The Internal Revenue Service ("IRS") may disqualify a retirement plan for failure to comply with the requirements of Section 401(a) and other provisions of federal laws.[551]

Most prominently, the City's direct use of SDCERS Surplus Earnings to fund retiree healthcare benefits starting in fiscal year 1983 through fiscal year 1992 violated IRC Section 401(a)(2), or the "exclusive benefit rule." In particular, this provision provides that, in order for a pension plan to be considered a qualified plan, it must be impossible "for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of [the employer's] employees or their beneficiaries."[552] U.S. Treasury Department regulations specify that, pursuant to this requirement, assets of a retirement plan must only be used for traditional retirement type benefits, a category which does not include payments for medical expenses.[553] Plainly, the City's direct reliance on SDCERS to pay for retiree healthcare benefits between 1982 and 1993 violated IRC Section 401(a). The IRS could disqualify the SDCERS Plan for this egregious violation of the "exclusive benefit rule."

The City's creation of a 401(h) account was, in theory, a valid exercise of its powers.[554] However, as implemented, the use of this trust to circumvent the "exclusive benefit rule" arguably violated the requirements of IRC Section 401(h) and, in turn, continued the violation of IRC Section 401(a).[555] The City was supposed to fund the 401(h) account independently to meet the required yearly premium payments for retirees' insurance policies (plus additional reserve amounts) in order to prevent the use of SDCERS assets for non-pension-related purposes.[556] However, the credit the City received from SDCERS toward its pension

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550 26 U.S.C. §§ 401(a), (h) (West 2006).

551 26 U.S.C. § 401(a)(2) (West 2006); 26 U.S.C. § 503(a)(1)(b) (West 2006); *Borrelli v. Sec'y of Treasury*, 343 F. Supp. 2d 249 (S.D.N.Y. 2004).

552 26 U.S.C. § 401(a)(2) (West 2006); 26 C.F.R. § 1.401-1(a)(3)(iv). This rule is also codified in Cal. Const. art. XVI, § 17(a)-(b), and San Diego City Charter, art. IX, § 145.

553 26 C.F.R. § 1.401-1(b)(1)(i). Importantly, the regulation provides an exception for the payment of medical benefits pursuant to IRC § 401(h), which requires the creation of a separate trust within a retirement plan. Id.; 26 U.S.C. § 401(h) (West 2006). Between 1982 and 1993, the City had not created such a trust and, arguably, the trust account it operated between 1993 and 1997 did not meet the requirements of IRC § 401(h), as it was administered by the City and maintained outside of the System. San Diego, Cal., Ordinance O-17770 (May 26, 1992).

554 26 U.S.C. § 401(h) (West 2006).

555 The City first created a separate trust for the payment of retiree health benefits in 1992, which was held outside of SDCERS. San Diego, Cal., Ordinance O-17770 (May 26, 1992). The City contributed $25.3 million to the trust and utilized its earnings to pay retiree healthcare benefits between FY 1993 and FY 1997, even though the City received an annual credit from Surplus Earnings for the retiree healthcare liability calculated each year. Ice Miller, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to SDCERS's Navigant Report Committee) (June 14, 2006). With the implementation of MP-1, a "true" 401(h) account was established and moved into SDCERS. San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997); San Diego Municipal Code § 24.1203.

556 Letter from Bob Blum, William M. Mercer, Inc., to Lawrence Grissom, Retirement Administrator (Mar. 13, 2000).

contribution – in the amount of the City's contribution to the Section 401(h) fund – arguably resulted in an indirect diversion of pension funds to cover retiree healthcare premiums. Thus, the System's Surplus Earnings, which were otherwise earmarked as pension assets, continued to bear the cost of the City's healthcare "contribution." While the IRC does permit transfers of "excess pension assets" in the pension fund to a 401(h) account under IRC Section 420, the Surplus Earnings were not sufficient to qualify as "excess" for purposes of an IRC Section 420 transfer exception.[557] The funding scheme arguably violated the Section 401(h) exception and the Section 401(a) requirements. Thus, the entire plan is subject to disqualification as a qualified defined benefit pension plan.

The City will likely argue that, as a technical matter, its bifurcated payment scheme implemented and developed between fiscal years 1993 and 2005 precluded the direct diversion of System assets to fund retiree healthcare, and thus avoided violating IRC Section 401(a)(2). However, even if the IRS were to agree, the City and SDCERS would necessarily have been violating the SDCERS "Plan Documents" during the relevant time period,[558] which would be considered an "Operational Failure" pursuant to IRS Rev. Proc. 2006-27.[559] In particular, both the City Charter and the Municipal Code require the City to contribute to the System at rates calculated by the SDCERS actuary.[560] By entering into MP-1 and MP-2, through which the City was able to avoid making contributions to SDCERS at actuarially calculated rates, the City caused its pension contribution to be deficient, violating the funding requirements of the Plan Documents.[561] The City exacerbated this Operational Failure through the bifurcated payment plan – by allocating a portion of its annual pension contribution toward the retiree healthcare cost and relying on Surplus Earnings to make up the shortfall, the City fell even further below the ARC, based on the SDCERS actuary's annual valuations.

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557 26 U.S.C. § 420 (West 2006); Letter from Bob Blum, William M. Mercer, Inc., to Lawrence Grissom, Retirement Administrator (Mar. 13, 2000). The Code mandates that, if a qualifying transfer is to be made out of a pension trust, the excess assets must be at least as sufficient as the applicable full-funding limitation in § 412(c)(7)(A). According to § 412, all of these calculations must be based on a "reasonable actuarial method of valuation." 26 U.S.C. § 412(c)(2) (West 2006). Plan funding decisions and methods must be reasonable in the aggregate and represent the actuary's professional judgment, not the tax-motivated wishes of plan sponsors or administrators. *Citrus Valley Estates, Inc. v. Commissioner*, 49 F.3d 1410, 1415 (9th Cir. 1995).

558 A qualified plan must be enacted and maintained pursuant to "Plan Documents" that consist of the laws, agreements, and statistical bases underlying the system, or the plan's "definite written program." 26 C.F.R. § 1.401-1(a)(2). Among other things, the SDCERS Plan Documents consist of California Constitution art. XVI, section 17; San Diego City Charter art. IX, sections 141-149; and San Diego Municipal Code sections 24.0100-24.1809. Letter from Ice Miller to Internal Revenue Service (July 12, 2005).

559 2006-22 I.R.B. 945 § 5.01(2)(b).

560 San Diego City Charter art. IX, § 143; Former San Diego Municipal Code § 24.0801 (repealed and amended Nov. 18, 2002).

561 City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal); San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); San Diego City Council Resolution R-297336 (Nov. 18, 2002).

Given the knowledge and intent with which City officials implemented this scheme over an extended period of time to reduce the City's annual pension contribution – or, put otherwise, to avoid paying for retiree healthcare – it is likely the IRS would view this Operational Failure as both significant and egregious.[562] Under whichever theory the IRS were to proceed, the SDCERS Plan could be disqualified and its tax-exempt status revoked.

The IRS's Employee Plans Compliance Resolution System ("EPCRS") enables a plan sponsor to communicate with the IRS as to the validity of any aspect of a plan or the effectiveness of a correction made by the sponsor on account of a past violation.[563] Two components of EPCRS facilitate this type of voluntary compliance monitoring: the Self-Correction Program ("SCP") and the Voluntary Correction Program ("VCP").[564] The third component, the Audit Closing Agreement Program ("Audit CAP"), arises after an audit has already begun.[565]

Notably, SDCERS has already submitted several compliance requests pursuant to VCP regarding, among other things, an Operational Failure related to the Presidential Leave benefit.[566] However, the components of EPCRS are "not available to correct failures relating to the diversion or misuse of plan assets."[567] Considering the willfulness of the City's use of SDCERS Surplus Earnings in the past to fund the "pay-as-you-go" retiree healthcare benefit – not to mention the contrivances of the City to skirt the requirements of the IRC by amending the Municipal Code and, later, the City Charter, upon the misgivings of tax counsel – it is unlikely the IRS would decline to pursue a full investigation of the City's breach of the most important requirement of IRC Section 401(a): the preservation and protection of System assets.

Moreover, the IRS could proceed against SDCERS and, in turn, the City on the basis of several "prohibited transactions" implicated by the MP-1, MP-2, and healthcare funding schemes.[568] A

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562 2006-22 I.R.B. 945 § 8.02; 2006-22 I.R.B. 945 § 4.11.

563 2006-22 I.R.B. 945 § 1.02.

564 2006-22 I.R.B. 945 § 4.01.

565 2006-22 I.R.B. 945 § 4.01.

566 As of May 1, 2006, the Ice Miller law firm, on behalf of SDCERS, had made several filings under the VCP and submitted a Request for Determination Letter (under Form 5300) to the IRS, seeking official approval of SDCERS's qualified tax-exempt status. Letter from Ice Miller to Internal Revenue Service (July 12, 2005); E-mail from Harvey Leiderman to David Callaghan (May 24, 2006). As of the issuance date of this Report, these filings were still pending.

567 2006-22 I.R.B. 945 § 4.12.

568 26 U.S.C. § 503(a)-(b) (West 2006). IRC Section 4975 provides the Department of Treasury and the IRS with a framework for the levy of excise taxes against plans that have engaged in prohibited transactions. 26 U.S.C. § 4975 (West 2006). However, this provision does not apply to IRC Section 414(d) governmental plans, such as SDCERS. 26 U.S.C. § 4975(g)(2) (West 2006).

qualified plan may lose its tax exemption if it "lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest" to the creator of the trust.[569] More broadly, the plan may lose its exemption if it "engages in any other transaction which results in a substantial diversion of its income or corpus" to the creator of the trust.[570] The IRS could find that, by allowing the City (the creator of the SDCERS Trust) to reduce its contributions to SDCERS (the plan) through MP-1 and MP-2 below the legally-required rates, SDCERS provided the City with an unsecured loan and pushed this liability off into the future.[571] At the very least, the use of SDCERS Surplus Earnings to fund retiree healthcare benefits resulted in a "substantial diversion" of System assets from their intended purpose, the funding of pension obligations. Thus, the IRS has several grounds on which it could disqualify SDCERS from tax-exempt status.[572]

However, it is unlikely the IRS would disqualify SDCERS from the tax exemption it has taken advantage of since inception.[573] Because the City is a governmental, not-for-profit entity, it has no taxable income from which to deduct its contributions to the System, one of the advantages of tax-exempt status.[574] Rather, the primary tax advantage SDCERS has received is the deferral of taxes on the benefits accruing to its participants.[575] Thus, the disqualification of the Plan would primarily hurt the beneficiaries of the system while not adversely affecting the City in any direct manner.

The IRS has a considerable amount of discretion in regard to actions it may take against the City for violations of the IRC. In a recent IRS investigation into the operations of several pension funds of the City of New York ("New York"), the IRS entered into a Closing Agreement with New York that waived

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569 26 U.S.C. § 503(a)(1)(B); 26 U.S.C. § 503(b)(1).

570 26 U.S.C. § 503(a)(1)(B); 26 U.S.C. § 503(b)(6).

571 Pursuant to the City Charter and the Municipal Code, the City was required to contribute to SDCERS at rates calculated by the SDCERS actuary. San Diego City Charter art. IX, § 143; Former San Diego Municipal Code § 24.0801 (repealed and amended Nov. 18, 2002). As previously mentioned, to the extent the bifurcated payment schedule for retiree healthcare allowed the City to further reduce its contributions below the ARC, the healthcare funding scheme also constituted a prohibited transaction.

572 IRC Section 503(a)(2) provides that a plan taking advantage of the tax exemption will be denied the exemption only after it has been notified by the Secretary of Treasury that it has engaged in a prohibited transaction. However, this penalty limitation does not protect plans that have "entered into such prohibited transaction with the purpose of diverting corpus or income of [the plan] from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such [plan]." 26 U.S.C. § 503(a)(2) (West 2006). Given the willfulness of both City and SDCERS officials in crafting and forwarding MP-1, MP-2 and the retiree healthcare funding schemes, the IRS could likely deny SDCERS's tax exemption retroactively for engaging in prohibited transactions.

573 San Diego Employees' Retirement System, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2003 at 46 (Dec. 1, 2003).

574 26 U.S.C. § 501(a) (West 2006).

575 26 U.S.C. § 501(a) (West 2006).

monetary sanctions against the municipality for similar violations of the IRC's governmental retirement plan qualification requirements and maintained the qualified status of the pension funds.[576] In particular, New York had amended three separate pension trust funds (serving police officers, firefighters, and general employees, respectively) to allow for the transfer of trust assets to a Variable Supplement Fund ("VSF") established within each pension fund.[577] Since the VSFs provided non-pension-related supplemental benefits to retirees in addition to regular pension benefits, the IRS concluded that the diversion of pension trust assets – in excess of $176 million – into the VSFs *and* to New York violated IRC Section 401(a)(2), the "exclusive benefit rule."[578] The IRS did not contend that the trust arrangements constituted prohibited transaction violations, which would have implicated the disqualification provision of IRC Section 503(a)(1)(B).[579] In lieu of disqualifying the pension trusts from tax-exempt status, the IRS mandated that New York repay the amount of the transferred assets.[580] The IRS also required that New York timely submit legislation to the New York State Legislature to amend the statutes governing the City pension trusts at issue to ensure future compliance with the qualification requirements of IRC Section 401(a)(2).[581]

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576 Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) (Jan. 31, 2003); *Borrelli v. Sec'y of Treasury*, 343 F. Supp. 2d 249, 252 (S.D.N.Y. 2004). In *Borrelli*, active and retired members of the pension plans at issue challenged, among other things, the discretionary action of the IRS to not disqualify the pension plans from tax-exempt status pursuant to IRC Section 503(a)(1)(B), claiming that the IRS acted beyond the scope of its authority. The United States District Court for the Southern District of New York held, among other things, that the plaintiffs had "failed to rebut the discretionary nature of the federal defendants' choice," noting that IRC Section 503(a)(1)(B) "tells the IRS *what* standard to enforce, but not *how* to enforce it." *Borrelli v. Sec'y of Treasury*, 343 F. Supp. 2d 249, 254-55 (S.D.N.Y. 2004) (emphasis in original). In reaching this decision, the court followed Supreme Court precedent that sets forth the presumption against reviewability of a federal agency's decision not to enforce. *See Heckler v. Chaney*, 470 U.S. 821 (1985).

577 *Borrelli v. Sec'y of Treasury*, 343 F. Supp. 2d 249, 252 (S.D.N.Y. 2004).

578 Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 3-4 (Jan. 31, 2003); 26 U.S.C. § 401(a)(2) (West 2006).

579 26 U.S.C. § 503(a)(1)(B) (West 2006).

580 Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4-5 (Jan. 31, 2003). Of particular import in the IRS's decision to not levy fines and disqualify the pension trusts was the financial crisis triggered by the 9/11 attacks: "Due to the unexpected fiscal crisis the City of New York is currently experiencing on account of the terrorist attacks of September 11, 2001, the Commissioner agrees to waive any sanction due from the City of New York as a result of the Commissioner's determination that the City of New York violated section 401(a)(2) of the Code." Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4 (Jan. 31, 2003). Notably, the IRS appears to have provided New York the opportunity to repay the transferred assets over time. The Closing Agreement states: "The Commissioner will treat subsequent contributions by the City of New York to the New York City Police Department Pension Fund, the New York Fire Department Pension Fund, and the New York City Employees' Retirement System, as repayment of the $176,986,000 transfer." Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4 (Jan. 31, 2003).

581 The IRS mandated that New York provide timely updates as to the status of the proposed legislation until the New York State Legislature adopted the proposed amendments. Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 5 (Jan. 31, 2003).

Although it is unlikely the IRS would disqualify SDCERS and punish its beneficiaries, the fact that it could do so provides considerable leverage to the IRS in shaping a remedy. Similar to its resolution of New York's pension fund violations, the IRS will likely exercise its authority to negotiate a closing agreement with the City pursuant to IRC Section 7121.[582] At the very least, it is likely that, like New York, the City will have to repay to SDCERS the assets (plus accrued interest) that it used directly from SDCERS Surplus Earnings to fund retiree healthcare benefits between fiscal years 1983 and 1992.[583] Moreover, the IRS may well contend that the City must repay to SDCERS the monies (plus accrued interest) that were transferred out of Surplus Earnings as a credit to the City's pension contribution against the retiree healthcare cost between fiscal years 1993 and 2005.[584] The IRS may also hold the City accountable – based on both Operational Failures and prohibited transactions – for the repayment of monies withheld from SDCERS below the actuarially calculated rates through the implementation of MP-1 and MP-2. The IRS will likely require that the City amend the Municipal Code and, if necessary, the City Charter, to ensure that SDCERS remains in compliance with the requirements of IRC Section 401(a) and IRC Section 401(h) in the future. It is unclear whether the IRS would pursue obtaining a large, non-statutory penalty against the City, in excess of the total amount of funds diverted and withheld from SDCERS. As mentioned above, however, SDCERS has already manifested a willingness to cooperate with the IRS in order to correct past failures.[585]

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582 26 U.S.C. § 7121 (West 2006).

583 Ice Miller LLC, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) at 13 (June 14, 2006).

584 The IRS could argue that the City must repay the collective amount of these credits on one of two theories: (1) the SDCERS assets were diverted toward non-pension-related benefits in violation of the "exclusive benefit rule;" or (2) the City caused an Operational Failure *and* engaged in a prohibited transaction by not paying the full amount of its legally-required pension contribution.

585 Based on the information available to this investigation, it appears that SDCERS is considering billing the City for funds expended by SDCERS directly from pension reserves between fiscal years 1983 and 1992 to pay for retiree healthcare benefits and associated administrative expenses (plus interest accrued). Ice Miller, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) at 12-18 (June 14, 2006). However, this amount only covers the direct use of Surplus Earnings for retiree healthcare benefits and does not account for the City's diversion of pension assets through its increasingly sophisticated healthcare funding schemes.